

BEFORE
THE PUBLIC SERVICE COMMISSION OF
SOUTH CAROLINA
DOCKET NO. 2002-122-E – ORDER NO. 2002-794
NOVEMBER 22, 2002

IN RE: Application of Lockhart Power Company for an)	ORDER
Increase in Electric Rates and Charges.)	APPROVING
)	RATES AND
)	CHARGES

INTRODUCTION

This matter comes before the Public Service Commission of South Carolina (“Commission”) on an Application filed by Lockhart Power Company (“Lockhart” or “Company”) whereby Lockhart proposed changes in the rates and charges for retail electric service provided by Lockhart. Pursuant to S.C. Code Ann. Section 58-27-860 (Supp. 2001), Lockhart, by letter dated April 9, 2002, notified the Commission that it would seek changes in its retail electric rates. Thereafter, on May 23, 2002, Lockhart filed its Application setting forth the proposed changes in rates and charges. According to Lockhart’s Application, the proposed rates and charges contained in the Application would produce an overall annual increase in retail revenues of \$167,505 over the per book retail revenues for the twelve-month period ending December 31, 2001.¹ These additional revenues represent approximately a 1.39% increase in Lockhart’s per book revenues attributable to Lockhart’s electric retail operations for the twelve-months ending

¹ Lockhart based its application and associated adjustments on a test year period comprised of the twelve-month period ending December 31, 2001.

December 31, 2001.² The total effect of the requested rates in the Application produces additional revenues of \$711,471.

According to the Application, Lockhart has been making investments to improve the operations of its generation, transmission, and distribution systems as well as major improvements to a portion of its earthen canal banks which provide a channel for water from Lockhart's Broad River Dam to Lockhart's hydroelectric facility in Lockhart, South Carolina. Consequently, according to the Application, Lockhart's return on rate base for its retail operations is only 8.34% for the twelve months ended December 31, 2001. According to the Application, Lockhart has proposed rates which would produce a rate of return on retail rate base of 11.75% during the test year after appropriate accounting and pro forma adjustments. Further, according to Lockhart's Application, a return on retail rate base of 11.75% is a fair and reasonable rate of return for Lockhart. Also, Lockhart intends to collect, from its retail customers during the first month the proposed rates are in effect, the unbilled revenue resulting from Lockhart's Purchased Power Adjustment Clause, the mechanics of which create a one-month delay in collection. Lockhart also requests that its reconnect fee be increased from \$5.00 to \$15.00.

The Commission's Executive Director instructed Lockhart to cause to be published a prepared Notice of Filing and Hearing once a week for three consecutive weeks in newspapers of general circulation in the areas affected by the Application. The Notice of Filing and Hearing indicated the nature of Lockhart's Application and advised all interested parties desiring to participate in the proceedings of the manner and time in

² While Lockhart's application reveals that the proposed rates produce an overall annual increase in retail electric revenues of 1.39%, each class of customers' average increase varies from this overall average.

which to file the appropriate pleadings for inclusion in the case. Lockhart was also required to notify directly all customers affected by the proposed rates and charges. Thereafter, Lockhart furnished affidavits demonstrating that the Notice of Filing and Hearing had been duly published in accordance with the instructions of the Executive Director. In addition, Lockhart certified that a copy of the Notice of Filing and Hearing had been mailed to each customer affected by the rates and charges proposed in the Company's Application.

The Consumer Advocate for the State of South Carolina ("Consumer Advocate") filed a Petition to Intervene in the proceeding.

Thereafter, pursuant to Notice provided in accordance with applicable provisions of law, a public hearing on the matters asserted in Lockhart's Application was held on September 18, 2002. M. John Bowen, Jr., Esquire represented Lockhart; Elliott F. Elam, Jr., Esquire represented the Consumer Advocate; and Florence P. Belser, Deputy General Counsel represented the Commission Staff. The record from the hearing consists of testimony from eight witnesses and eight hearing exhibits. Lockhart presented as witnesses Leslie S. Anderson, Charles R. Parmelee, Paul W. Inman, and Paul R. Moul, and the Commission Staff presented as witnesses Dr. James E. Spearman, Vivian B. Dowdy, Eddie Coates, and A.R. Watts. The Consumer Advocate did not present any witnesses at the hearing.

FINDINGS OF FACT

Based upon the evidence of record from this proceeding, the Commission makes the following Findings of Fact. The discussions of supporting evidence and associated

conclusions regarding each Finding of Fact are contained in subsequent sections of this Order.

1. Lockhart is a public utility operating in South Carolina where it is engaged in the generation, transmission, distribution, and sale of electricity to the public for compensation. Lockhart's retail electric operations in South Carolina are subject to the jurisdiction of this Commission pursuant to S.C. Code Ann. Section 58-27-10, et seq. (1976), as amended.

2. The test period established for the purposes of this proceeding is the twelve-month period ending December 31, 2001, adjusted for certain known and measurable changes.

3. Lockhart is seeking approval of rates and charges for its South Carolina retail electric operations which would produce additional annual revenues of \$711,471 or a \$167,505 annual increase over present test year per book revenues.

4. Lockhart's presently approved rates and charges, as adjusted and allocated to South Carolina retail electric operations, produce Operating Revenues of \$11,472,633.

5. The reasonable test year Operating Expenses for Lockhart's South Carolina retail electric operations, after pro forma adjustments and prior to the effect of the proposed increase approved herein, are \$10,448,239.

6. The appropriate Operating Expenses for Lockhart's South Carolina retail electric operations after approval of the rates and charges herein are \$10,711,169.

7. Lockhart's retail electric Total Income for Return after accounting and pro forma adjustments and after the effect of the increase in the rates and charges approved herein is \$1,477,943.

8. Lockhart's original cost rate base allocated to South Carolina retail electric operations for the test year after approved accounting and pro forma adjustments is \$12,631,948.

9. The capital structure utilized by the Commission in this proceeding for the determination of the fair overall rate of return is the existing capital structure of Lockhart which is comprised of 100% equity with no debt.

10. The fair rate of return on common equity, which Lockhart should be allowed a reasonable opportunity to earn, is 11.25% to 11.75%.

11. Based upon the specific findings and conclusions herein, Lockhart's annual revenue requirement for its South Carolina retail electric operations is \$12,184,104, which will allow Lockhart a reasonable opportunity to earn a rate of return on its jurisdictional rate base of 11.25% to 11.75% which the Commission finds just and reasonable. The rates approved herein are intended to produce additional net revenues for South Carolina retail electric operations of \$644,274, after accounting and pro forma adjustments.

12. The cost of service methodology, rate design, and rate schedules, with the exception of the base amount of the Purchased Power Adjustment clause, as proposed by Lockhart are appropriate and should be adopted for the purpose of this proceeding, including an increase in the reconnect fee from \$5.00 to \$15.00.

EVIDENCE SUPPORTING FINDINGS OF FACT AND CONCLUSIONS

1. Lockhart is a public utility operating in South Carolina where it is engaged in the generation, transmission, distribution, and sale of electricity to the public for compensation. Lockhart's retail electric operations in South Carolina are subject to the jurisdiction of this Commission pursuant to S.C. Code Ann. Section 58-27-10, et seq. (1976), as amended.

The evidence to support this finding concerning the legal and operational descriptions of Lockhart and its jurisdictional business is contained in the Application submitted. By its Application, Lockhart acknowledges that it is a public utility operating in South Carolina and further acknowledges that its rates for electric service to the public (i.e. retail rates) are made, fixed, and allowed by this Commission. Application, p. 1.

2. The test period established for the purposes of this proceeding is the twelve-month period ending December 31, 2001, adjusted for certain known and measurable changes.

The evidence for this finding is contained in Lockhart's Application and in the testimony and exhibits of Lockhart's witnesses. The Application and its accompanying exhibits were based upon a test year consisting of the twelve months ending December 31, 2001. Application, p. 1- 2, ¶ 1 and Exhibits to Application. The witnesses for the Commission Staff likewise offered their evidence within the context of the same period.

A fundamental principle of the ratemaking process is the establishment of a test year period. The purposes of the test year are to provide a definite period to audit and to provide a definite period on which to estimate future revenue requirements. The reliance

on the test year concept, however, is not designed to preclude the recognition and use of other data that may precede or postdate the selected twelve-month period.

Integral to the use of the test year, representing normal operating conditions to be anticipated in the future, is the necessity to make normalizing adjustments to the historic test year figures. Only those adjustments which have reasonable and definite characteristics and which tend to influence reflected operating experience are made to give proper consideration to revenues, expenses and investments. Parker v. South Carolina Public Service Commission, et al, 280 S.C. 310, 313 S.E.2d 290 (1984). Adjustments may be allowed for items occurring in the historic test year, but which will not recur in the future, or to give effect to items of an extraordinary nature by either normalizing or annualizing such items to reflect more accurately their annual impact, or to give effect to any other item which should have been included or excluded during the historic test year.

Based upon the evidence of record, the Commission concludes that the twelve months ending December 31, 2001, is the reasonable period upon which to make our ratemaking determinations herein. The relevant evidence of record and Lockhart's discovery responses have been submitted using the twelve-month period ending December 31, 2001.

3. Lockhart is seeking approval of rates and charges for its South Carolina retail electric operations which would produce additional annual revenues of \$711,471 or a \$167,505 annual increase over present test year per book revenues.

In its Application, Lockhart asserts that the rates proposed in the Application will produce an overall increase in revenues of 1.39%, or a \$167,505 annual increase, over present test year per book retail revenue. Application, p. 2, ¶ 4. Staff also calculates the increase in test year per book revenues from the proposed rates as \$167,505. Prefiled Testimony of Coates, p. 2, ll. 1-10. Per book test year retail electric operating revenues are \$12,083,796. Application, Exhibit A-4; Hearing Exhibit 4, Audit Exhibit A; Hearing Exhibit 5, Exhibit No. 3. Test year retail electric revenues after Lockhart's proposed accounting and pro forma adjustments and after the effect of the proposed increase are \$12,251,301. Application, Exhibit A-4; see also Hearing Exhibit No. 5, Exhibit No. 3.

The full effect of the proposed rates would produce additional revenues of \$711,471. Application, Exhibit A-4; Hearing Exhibit 4, Audit Exhibit A and Audit Exhibit A-1, p. 11 of 12; Hearing Exhibit 5, p. 3, ¶ 17. The retail electric revenues after Lockhart's proposed accounting and pro forma adjustments and after the effect of the proposed increase reflect an increase in the Purchase Power Adjustment base amount from the previously approved 3.2672 cents per KWH to 3.4789 cents per KWH. Prefiled Testimony of Coates, p. 2, ll. 5-8; Hearing Exhibit 5, Exhibit No. 3; compare Application "Present Rates – Schedule O" with Application "Proposed Rates – Schedule O."

4. Lockhart's presently approved rates and charges, as adjusted and allocated to South Carolina retail electric operations, produce Operating Revenues of \$11,472,633.

Lockhart's per book test year South Carolina retail electric Operating Revenues are \$12,083,796. Application, Exhibit A-4; Hearing Exhibit 4, Audit Exhibit A; Hearing

Exhibit 5, Exhibit No. 3. The Commission herein adopts total adjustments to South Carolina retail Operating Revenues which decrease test year jurisdictional Operating Revenues by \$611,163. The individual adjustments are discussed below.

(a) **Purchased Power** - Both Lockhart and the Staff propose a reduction to system revenues to reflect a pro forma decrease in Purchased Power costs. Lockhart proposes an adjustment of (\$969,067) with (\$563,474) being attributable to South Carolina retail operations. Lockhart proposes the adjustment in Purchased Power to offset the effects of drought during the test year. Lockhart's reasoning is that the severe drought during the test year has resulted in hydroelectric generation being less than average resulting in an abnormal increase in Purchased Power expense. Application, Exhibit A-1 and A3-4. Lockhart's proposed adjustment reflects the average generation level over the last thirty years. *Id.* Lockhart also makes corresponding adjustments to Taxes Other Than Income expense of (\$3,415) of which (\$1,983) is attributable to jurisdictional operations and to Income Taxes expense of \$1,274 of which \$448 is attributable to jurisdictional operations.

Staff proposes an adjustment for Purchased Power identical to that proposed by Lockhart. Staff's corresponding adjustments to Taxes Other Than Income expense and Income Taxes expense differ from those proposed by Lockhart. Staff proposes an adjustment to Taxes Other Than Income expense of (\$1,253) of which (\$728) is attributable to jurisdictional operations. Hearing Exhibit 4, Audit Exhibit A-1, p. 1 of 12. Staff's adjustment is based on a gross receipt tax rate of 0.001293 where Lockhart uses a tax rate of 0.003524 to calculate Taxes Other Than Income. *Id.*

Lockhart provided data on mean annual streamflow for the past fifty-six years (1946-2001). Amendment to Application, Letter dated August 28, 2002, with attachments and Letter dated September 18, 2002, with attachments. For the past thirty years (1972 – 2001), Lockhart calculated the arithmetic mean of annual generation to be 78.4 GWH. Amendment to Application, Letter dated August 28, 2002, Attachment 4.

While the thirty-year median was not provided by Lockhart, the data provided by Lockhart reveals that the median of annual generation for the past thirty years (1972-2001) is 83.4 GWH. Total test year generation reported by Lockhart was 36.0 GWH. Calculating Purchased Power expense using the thirty-year mean, or average, of 78.4 GWH produces a difference in generation of 42.4 GWH. Applying the Purchased Power Energy Cost of \$0.022871 to 42.4 GWH, results in a difference in Purchased Power expense for the test year of \$969,067. Calculating Purchased Power expense using the thirty-year median produces a difference in generation of 47.4 GWH. Applying the Purchased Power Energy Cost of \$0.022871 to 47.4 GWH, results in a difference in total company Purchased Power expense for the test year of \$1,084,794.

The Commission agrees that an adjustment to Purchased Power is needed to normalize the test year in order to negate the effect of the severe drought which required Lockhart to purchase an unusual amount of power. However, the Commission finds that the adjustment for Purchase Power is more appropriately based on the median generation for the past thirty-year period rather than on the arithmetic mean, or average, generation of the past thirty years. While the purpose of the test year is to provide a definite period to audit and on which to estimate future revenue requirements, the use of a test year does

not preclude the recognition and use of other historical data that may precede or postdate the test year. Further, adjustments which have reasonable and definite characteristics and which tend to influence reflected operating experience are made to give proper consideration to revenues, expenses and investments.

When hydro generation data are skewed, as is the case of a severe drought during a test year, the median provides a more robust indicator of the probability of the future likelihood of annual generation and associated power purchases. When examining a distribution, as is the case of annual generation for the past thirty years, the center of distribution must be located. The center of a distribution can be measured by the mean, which is the arithmetic average, or by the median, which is the midpoint. A weakness of the mean as a measure of center is that it is sensitive to the influence of a few extreme observations, whether the extreme observations are outliers or reflect a skewed distribution. On the other hand, the median as a measure of center is a resistant measure of center. The median not only limits the influence of outliers, but its value does not respond strongly to changes in a few observations, no matter how large those changes may be. When the test year data are skewed, either high or low, the arithmetic average, or mean, will not provide an accurate prediction of the required pro forma adjustment. Thus, the Commission finds the use of the median, a resistant measure of center, to be the proper indicator on which to base the adjustment for Purchased Power.

(b) Reclassification of Revenue - Both Lockhart and the Staff proposed an adjustment of \$18,727 to correct test year revenues for two billing adjustments made during the test period where the problem actually occurred outside the test year. Lockhart

stated the adjustment to revenues was to reverse two large billing corrections for prior years. Application, Attachment A-1. Staff concurred with the Lockhart proposed adjustment to correct test year revenues attributed to two billing adjustments necessary to reverse the effect for the out of test year billing error. Watts Testimony, p. 3, ll. 3-8; Dowdy Testimony, p. 6, ll. 12 – 16; Hearing Exhibit 4, Audit Exhibit A-1, p. 1 of 12; Hearing Exhibit 5, p. 2, ¶ 1. The difference in Lockhart's proposed adjustment and the Staff's proposed adjustment relates to the gross receipt tax rate to calculate Taxes Other Than Income related to this adjustment. Lockhart proposed use of a gross receipt tax rate of 0.003524 while Staff proposed use of a gross receipt tax rate of 0.001293. Dowdy Testimony, p. 6, ll. 14-16; Hearing Exhibit 4, Audit Exhibit A-1, p. 1 of 12.

The Commission finds the adjustment proposed by Staff reasonable as this adjustment corrects test year revenues for an out of period billing. Further, the Commission finds the use of the gross receipt tax rate of 0.001293 as proposed by the Staff to be the proper gross receipt tax rate as this gross receipt tax rate is the most recent factor. Dowdy Direct Testimony, p. 12, ll. 18-20.

Total Effect of Adjustments to Operating Revenues - The result of the above-adopted adjustments decreases per book Operating Revenues by \$1,066,067 for total electric operations and decreases per book Operating Revenues for South Carolina retail operations by \$611,163. Lockhart and the Staff show test year per book Operating Revenues of \$18,562,192 for total electric operations and per book Operating Revenues for South Carolina retail operations of \$12,083,796. After the pro forma and accounting adjustments adopted above, Lockhart has as adjusted Operating Revenues of \$17,496,125

for total electric operations and as adjusted Operating Revenues of \$11,472,633 for South Carolina retail operations.

5. The reasonable test year Operating Expenses for Lockhart's South Carolina retail electric operations, after pro forma adjustments and prior to the effect of the proposed increase approved herein, are \$10,448,239.

Adjustments affecting operating expenses were included in the testimony and exhibits offered by witnesses for Lockhart and the Staff. The operating expenses for Lockhart's South Carolina retail operations after the pro forma adjustments adopted herein and prior to the effect of the rate increase approved by this Order are \$10,448,239. The specific accounting and pro forma adjustments are discussed below.

(a) Purchased Power Expense – Lockhart proposed a reduction to Purchased Power expense to address the lost generation due to drought conditions occurring during the test year. Lockhart proposed a reduction of (\$969,067), of which (\$563,474) is attributable to South Carolina retail operations. Application, Exhibit A3-5 and A3-4. Staff agreed with Lockhart's adjustment and proposed the same adjustment as Lockhart. Dowdy Testimony, p. 6, ll. 17 - 22; Hearing Exhibit No. 4, Audit Exhibit A-1, p. 1 of 12. The adjustment proposed by Lockhart and the Staff was based on the average, or mean, generation level over the last thirty years (1972-2001).

Upon consideration of this adjustment, the Commission finds that the adjustment to Purchase Power expense should be based upon the median level of generation over the last thirty years (1972-2001). As discussed with regard to the Purchased Power adjustment to Lockhart's revenues, the median provided a more robust indicator of the

probability of future annual generation and associated Purchased Power. *See*, Finding of Fact 4 and corresponding discussion.

(b) **Wages** - Lockhart proposed adjustments to account for a wage increase of 4.00% for hourly employees which became effective on or after May 20, 2001. Application, Exhibit A3-5; Inman Testimony, p. 2, ll. 7 – 17; Hearing Exhibit 2, Exhibit PWI-1. Lockhart also proposed an adjustment to Salaried and Administrative employees. Inman Testimony, p. 2, l. 18 – p. 3, l. 3; Hearing Exhibit 2, Exhibit PWI-2; Application, Exhibit A3-6. Lockhart's total wage and fringe benefits adjustments of \$34,135 consists of \$23,305, of which \$17,397 is attributed to jurisdictional operations, to Operation and Maintenance ("O&M") expense and \$10,830, of which \$8,811 is attributed to jurisdictional operations, to Administrative and General expense. Lockhart did not capitalize any part of the increase in fringe benefits associated with the wage increase. Dowdy Testimony, p. 7, ll. 16-17. Further, Lockhart included the FICA portion of its adjustment as O&M expense and Administrative and General expense. Dowdy Testimony, p. 8, ll. 1 -3.

Staff proposed to adjust expenses for the effect of annualizing payroll costs as of December 31, 2001. Dowdy Testimony, p. 7, ll. 1-4, Hearing Exhibit 4, Audit Exhibit A-1, p. 2 of 12. Staff's adjustment annualized payroll expenses using actual payroll costs as of December 31, 2001. *Id.* Staff expensed a portion of the wage adjustment based on actual wages expenses during the test year. *Id.* Staff calculated the expense portions to be 76.69% for hourly employees and 91.62% for salaried and administrative employees. *Id.* Staff's total adjustment for wages and fringe benefits is \$33,329 and is composed of a

\$20,993 adjustment to O&M expense, of which \$15,671 is attributable to jurisdictional operations; a \$10,102 adjustment to Administrative and General expense, of which \$8,218 is attributable to jurisdictional operations; and a \$2,234 adjustment to Taxes Other Than Income, of which \$1,777 is attributable to jurisdictional operations. Dowdy Testimony, p. 7, ll. 9-12; Hearing Exhibit No. 4, Audit Exhibit A-1, p. 2 of 12. In its adjustments, Staff capitalized fringe benefits in the amount of \$968, which has the effect of reducing the expense portion of the wage increase. Dowdy Testimony, p. 7, ll. 16 -22; Hearing Exhibit No. 4, Audit Exhibit A-1, p. 2 of 12. Staff used a rate of 14.13% as compared to Lockhart's 13.68%, resulting in an additional \$162 in fringe benefits expense. *Id.* Staff also proposed to show its \$2,234 FICA adjustment as Taxes Other Than Income expense, while Lockhart included FICA in O&M expense and Administrative and General expense. Dowdy Testimony, p. 8, ll. 1-5; Hearing Exhibit No. 4, Audit Exhibit A-1, p. 2 of 12.

Upon consideration of this adjustment, the Commission finds the Staff's adjustment appropriate. The Commission finds the Staff's treatment of the wage increase where Staff annualized payroll costs using actual payroll costs at the end of the test year to be an appropriate measure of annualized payroll costs. Further, the Commission finds the Staff's treatments of associated adjustments such as capitalizing a portion of the fringe benefits, including FICA as Taxes Other Than Income expense rather than O&M expense and Administrative and General expense to be correct. Further, the Commission would note that Lockhart did not object to the Staff's proposed adjustments.

(c) **Reconnect Fee** – In its Application, Lockhart seeks to increase its reconnect fee from \$5.00 to \$15.00. The reconnect fee is a charge made to reconnect customers who have been disconnected for non-payment of electric bills. When a reconnect fee is charged, Lockhart offsets the revenue collected for reconnection against the expenses incurred for reconnection. Thus an increase in reconnect fees will decrease O&M expense associated with the reconnection expenses. Lockhart proposed to show the increase in its reconnect fee in the test year expenses and proposed an adjustment of (\$4,970) to O&M expense, with (\$4,823) attributable to jurisdictional operations. Application, Exhibit A3-1 and A3-8; Dowdy Testimony, p. 8, ll. 6-14; Hearing Exhibit 4, Audit Exhibit A-1, p. 3 of 12. Staff did not propose an adjustment to test year expenses associated with the requested increase in the reconnect fee but treated the increase as part of the proposed increase.

The effects of the adjustment by Lockhart and the treatment by Staff produce no difference. Lockhart just showed the increase in the test year and removed it. Staff did not adjust the test year but treated the increase in the Reconnect Fee as part of the proposed increase.

(d) **Legal Expenses** – Both Lockhart and Staff propose to decrease legal expenses to reflect a three-year amortization of higher than normal legal expenses. During the test year, Lockhart booked legal expenses of \$107,018. Application, Exhibit A3-9. For the five-year period preceding the test year, Lockhart averaged legal expenses of \$21,209. *Id.* The increase in legal expenses during the test year was due to Lockhart's participation in the Regional Transmission Organization ("RTO") process required by the

Federal Energy Regulatory Commission (“FERC”). *Id.* Lockhart and Staff propose an adjustment of (\$57,206), of which (\$46,540) is attributed to jurisdictional operations, to amortize the legal expenses in excess of the five year average over a three year period. Dowdy Testimony, p. 9, ll. 1- 12; Hearing Exhibit 4, Audit Exhibit A-1, p. 4 of 12.

The Commission finds the proposal suggested by Lockhart and Staff to be reasonable. The effect of the adjustment is to normalize an otherwise abnormal expense item. The Commission is well aware of the RTO process before the FERC and finds that the legal expenses spent by Lockhart in connection with those proceedings to be necessary. However, the Commission is also mindful that the test year must reflect normal operations and therefore approves the proposed adjustment which normalizes the expense.

(e) Rate Case Expenses – Lockhart proposes an adjustment of \$16,600 for costs included in connection with the current rate proceeding. Application, Exhibit A3-10. Lockhart shows costs of \$49,800 for the current rate case and proposes to amortize those costs over a three year period resulting in an adjustment to test year expenses of \$16,600. *Id.*

Staff proposed an adjustment of \$18,183 which was calculated using actual rate case expenses of \$54,550 as of July 11, 2002, which was the date of the Staff audit, amortized over a three year period. Dowdy Testimony, p. 9, l. 13 – p. 10, l. 2; Hearing Exhibit 4, Audit Exhibit A-1, p. 5 of 12. Staff’s adjustment is higher than Lockhart’s because Lockhart’s adjustment was based on expenses known at the time of the filing of the application. *Id.*

Upon consideration of this adjustment, the Commission finds the Staff's adjustment to be the appropriate adjustment for rate case expenses. The Staff's adjustment is based on actual rate case expenses incurred as of the Staff audit on July 11, 2002. Further, the Commission finds that the amortization period for the rate case expenses of three years to be an appropriate recovery mechanism for the expenses.

(f) Interest on Customer Deposits - Staff proposed an adjustment to Interest on Customer Deposits of \$189. Staff's adjustment is made to annualize the test year interest on customer deposits by applying the Commission approved interest rate of 8.00% to the year-end Customer Deposits of \$84,564. This resulted in an annualized test year amount of \$6,765 for Interest on Customer Deposits. Per book Interest on Customer Deposits amounted to \$6,576. Thus, Staff proposed the adjustment to increase Interest on Customer Deposits by \$189. Dowdy Testimony, p. 10, ll. 3-10; Hearing Exhibit No. 4, Audit Exhibit A-1, p. 5 of 12.)

Upon consideration of this adjustment, the Commission finds that this adjustment should be adopted. For ratemaking purposes, expense accounts should be normalized to reflect the actual conditions of Lockhart.

(g) Depreciation Expense – Lockhart proposed an adjustment to Depreciation expense to annualize the expense for the test year. According to witness Inman, provisions for depreciation on capital expenditures during the test year were made as the assets were placed in service throughout the year. Application, Exhibit A3-2 and A3-11; Inman Testimony, p. 4, ll. 13 -21. Hearing Exhibit 2, Exhibit PWI-7. Lockhart's proposed adjustment of \$26,594, with \$19,642 attributable to jurisdictional operations, was made

on net plant additions during the test year. *Id.* Associated with Lockhart's proposed adjustment is a corresponding adjustment to Income Taxes expense of (\$9,920), of which (\$7,326) is attributable to South Carolina operations. Hearing Exhibit 4, Audit Exhibit A-1, p. 6 of 12.

Staff also proposed an adjustment to annualize test year Depreciation expense. Staff's adjustment of \$47,954, with \$36,024 attributable to jurisdictional operations, was made on the year-end plant balance of \$32,270,802. Testimony of Dowdy, p. 10, ll. 11-15; Hearing Exhibit 4, Audit Exhibit A-1, p. 6 of 12. Associated with this adjustment is a corresponding adjustment to Income Tax expense of (\$17,887), of which (\$13,437) is attributable to South Carolina retail operations. *Id.*

The Commission finds the Staff's proposed adjustment reasonable and adopts Staff's adjustment in this proceeding. The adjustment is computed using the year-end plant balance at the appropriate depreciation rate. By using the year-end plant balance, Lockhart receives a full year's depreciation for plant additions during the test year.

(h) Property Taxes - Both Lockhart and Staff propose an adjustment to annualize property taxes based on Net Plant in Service and on Material and Supplies Inventory as of December 31, 2001. Lockhart's proposed adjustment is \$48,726, with \$38,763 attributable to South Carolina operations, and a corresponding adjustment to income taxes expense of (\$18,175), with (\$14,459) attributable to South Carolina operations. Application, Exhibit A3-12; Inman Testimony, p. 5, ll. 1 -12; Hearing Exhibit 2, Exhibit PWI-8; Hearing Exhibit 4, Audit Exhibit A-1, p. 6 of 12. Staff's adjustment is \$49,201, with \$39,141 attributable to South Carolina operations, and a corresponding

adjustment to Income Taxes expense of (\$18,352), with (\$14,600) attributable to jurisdictional operations. Dowdy Testimony, p. 10, ll. 16-22; Hearing Exhibit 4, Audit Exhibit A-1, p. 6 of 12. The effect of the adjustment is to annualize property taxes on new plant additions at the end of the test year.

The Commission adopts the adjustment proposed by the Staff. The difference in the Staff's adjustment and Lockhart's adjustment is because the Staff's pro forma adjustments made to Accumulated Depreciation resulted in a higher tax base than the adjustment made to Accumulated Depreciation made by Lockhart. As the Commission adopts the Staff's adjustment to Accumulated Depreciation, it is appropriate for the Commission to adopt the Staff's adjustment to Depreciation expense. *See*, adjustment for "Accumulated Depreciation" under Finding of Fact No. 8.

(i) **Non-allowables** – Staff proposed to adjust O&M expense by (\$8,833) and Administrative and General expense by (\$115). Staff's adjustments are to remove items that Staff considered "non-allowable" for ratemaking purposes. Staff removed expenses such as incentive awards, donations, institutional advertising, civic dues, and goodwill advertising. Dowdy Testimony, p. 11, ll. 1-6; Audit Exhibit A-1, p. 7 of 12.) Lockhart did not propose an adjustment for non-allowables.

Upon consideration of this matter, the Commission finds that the Staff's adjustment should be adopted. Items such as those which the Staff removed are items which are not necessary to providing service and should be treated as below-the-line expenses for ratemaking purposes.

(j) Revenue-Related Taxes –Lockhart adjusted Taxes Other Than Income by (\$3,415), of which (\$1,983) is attributable to South Carolina retail operations, and increased Income Tax expense by \$1,274, of which \$448 is attributable to South Carolina retail operations. Hearing Exhibit 4, Audit Exhibit A-1, p. 1 of 12. Staff proposed adjustments of (\$1,253), of which (\$728) is attributable to South Carolina retail operations, to Taxes Other Than Income, and \$467, of which (\$20) is attributable to South Carolina retail operations, to Income Tax expense. *Id.* Lockhart's adjustment was based on the use of its proposed Purchase Power revenue adjustment to revenues and the use of a factor of 0.003524 to calculate Taxes Other Than Income. *Id.* The Staff's adjustment was based on the use of its proposed Purchase Power revenue adjustment and a gross receipt tax factor of 0.001293, which according to witness Dowdy was the most recent gross receipt tax factor available. Dowdy Testimony, p. 12, ll. 18 – 20.

As the Commission has adopted a Purchased Power revenue adjustment based on the thirty year median rather than the thirty year mean proposed by Lockhart and the Staff, the Commission finds it appropriate to recalculate Taxes Other Than Income. The Commission adopts the factor used by the Staff as the Staff's gross receipt factor is the most recent gross receipt tax factor. Dowdy Testimony, p. 12, ll. 18 – 22. Accordingly, the Commission adopts an adjustment to Taxes Other Than Income of (\$1,403), with (\$815) attributable to South Carolina operations, and an adjustment to Income Taxes expense of \$523, with (\$22) attributable to South Carolina jurisdictional operations.

Total Effect of Adjustments to Operating Expense - The effect of the adjustments adopted above adjust per book Operating Expenses for South Carolina retail

operations by (\$584,651). Per book Operating Expenses for South Carolina retail operations for the test year amount to \$11,032,890. Applying the adjustments approved herein to the per book South Carolina retail operations Operating Expenses results in as adjusted Operating Expenses for South Carolina retail operations, prior to the proposed increase, of \$10,448,239.

6. The appropriate Operating Expenses for Lockhart's South Carolina retail electric operations after approval of the rates and charges herein are \$10,711,170.

The derivation of Lockhart's operating expenses of \$10,711,170 is based upon Findings of Fact Nos. 5, 10, 11, and 12. Operating Expenses, as adjusted prior to the increase, for South Carolina retail electric operations are \$10,448,239. *See*, Finding of Fact No. 5. Adjustments associated with the herein approved allowed revenues of \$711,471 (*See*, Finding of Fact No. 12) were computed for Taxes Other Than Income and for Income Taxes. Staff computed an adjustment of \$920 for Taxes Other Than Income and an adjustment of \$266,834 for Income Taxes. Hearing Exhibit No. 4, p. 6, Audit Exhibit A. Adding these adjustments to the as adjusted South Carolina retail operations Operating Expenses results in South Carolina retail operations Operating Expenses after approval of the rates and charges of \$10,711,170.

7. Lockhart's retail electric Total Income for Return after accounting and pro forma adjustments and after the effect of the increase in the rates and charges approved herein is \$1,477,943.

The derivation of Lockhart's Income for Return after the effect of the rates approved herein is \$1,477,943. This amount was computed using the Operating

Revenues after the proposed increase of \$12,184,104 (*See*, Finding of Fact 11) less Operating Expenses of \$10,711,170 (*See*, Finding of Fact 6) and adding Customer Growth of \$5,009.

With regard to the Customer Growth calculation, Lockhart and the Staff both proposed to adjust Customer Growth to reflect the increase in Operating Revenues and Operating Expenses. Dowdy Testimony, p. 8, ll. 15 -21 and p. 13, ll. 1-3; Hearing Exhibit 4, Audit Exhibit A-1, p. 11 of 12; Hearing Exhibit 4, Audit Exhibit A-2. The Customer Growth formula proposed by Staff utilized end of test year customers of 6,196 minus test year average customers of 6,175 divided by the test year average customers of 6,175. *Id.* Staff's calculation produced a Customer Growth factor of 0.003401. *Id.*

Due to the Commission's adoption of different adjustments, particularly the adjustment to Purchase Power revenues and expense based on median hydro generation rather than mean hydro generation, the Commission must recalculate the customer growth adjustment. The Commission adopts the formula proposed by Staff, and the recalculated Customer Growth adjustment is \$1,525 after accounting and pro forma adjustments and after the effect of the herein approved increase in rates and charges. Adding the recalculated Customer Growth adjustment of \$1,525 to the as adjusted Customer Growth of \$3,484 produces Customer Growth of \$5,009 after the proposed increase.

To account for Operating Income for Return, we must add the Customer Growth of \$5,009 to the Operating Revenues after the rates and charges approved herein of

\$12,184,104 and subtract the Operating Expenses after the rates and charges approved herein of \$10,711,170. The result is Operating Income for Return of \$1,477,943.

8. Lockhart's original cost rate base allocated to South Carolina retail electric operations for the test year after approved accounting and pro forma adjustments is \$12,631,948.

Pursuant to S.C. Code Ann. Section 58-27-180 (1976), the Commission has the authority after hearing to ascertain and fix the value of the property of an electrical utility. In the context of a ratemaking proceeding, such authority is exercised in the determination of the electrical utility's rate base.

For ratemaking purposes, the rate base is the total net value of the electrical utility's tangible and intangible capital or property value on which the utility is entitled to earn a fair and reasonable rate of return. The rate base, as allocated or assigned directly to Lockhart's retail electric operations, is composed of the value of Lockhart's property used and useful in providing retail electric service to the public, plus construction work in progress, materials and supplies, and allowance for cash working capital. The rate base computation incorporates reductions for the reserve for depreciation and amortization, accumulated deferred income tax, and customer deposits. In accordance with its standard practice, the Audit Department of the Staff conducted an audit and examination of Lockhart's books, and verified all account balances from Lockhart's general ledger, including rate base items, with plant additions and retirements. On the basis of Staff's audit, the pertinent hearing exhibits, and the testimony contained in the record of the

hearing, the Commission can determine and find proper balance for the components of Lockhart's rate base, as well as the propriety of related accounting adjustments.

For ratemaking purposes, this Commission has traditionally determined the appropriate rate base of the affected utility at the end of the test year period. Determination of a utility's rate base on a "year end" basis serves to enhance the timeliness of the effect of such action and preserves the reliance on historical and verifiable accounts without resort to speculative or projected figures. With this reasoning in mind, the Commission finds it most reasonable to retain its practice of evaluating the issues of the instant proceeding founded on a rate base for Lockhart's retail electric operations as of December 31, 2001.

When the rate base has been established, Lockhart's total operating income for return is applied to the rate base to determine what adjustments, if any, to the present rate structure are necessary to generate earnings sufficient to produce a fair rate of return. The rate base should reflect the actual investment made by investors in Lockhart's property and the value upon which the investors will receive a return on their investment.

By its Application, Lockhart stated its Original Cost Year-end Rate Base for South Carolina retail operations, prior to accounting and pro forma adjustments, as \$12,630,334 and after Lockhart's proposed accounting and pro forma adjustments as \$12,611,698 (Application, Attachment A4.) According to Lockhart witness Anderson, this amount reflects a 7.5% increase over Lockhart's retail rate base in 1999, the cost basis year of Lockhart's last rate case. Anderson Testimony, p. 2, ll. 10 – 12; Hearing Exhibit 1, Exhibit LSA-1. Lockhart witness Anderson testified that Lockhart had made

investments in three large categories: (1) to improve efficiencies and/or control or reduce costs; (2) to provide for customer growth and improve service, and (3) to replace obsolete equipment. Anderson Testimony, p. 2, ll. 3 – 6. Additionally, Lockhart was required by FERC to make major improvements to a portion of the earthen canal banks which channel water from Lockhart's Broad River Dam to Lockhart's hydroelectric facility at a cost of approximately \$1,200,000. Anderson Testimony, p. 2, ll. 6 -10.

With regard to specific improvements and replacements in equipment, Lockhart has replaced three large power transformers, two rated at 5,000 KVA and one rated at 3,750 KVA, with more efficient transformers. Anderson Testimony, p. 6, ll. 17-22. The older transformers had electrical losses of 5.5%, and the new transformers have losses rated at only 0.5%. *Id.* The replacement transformers should result in an annual savings in electrical losses of approximately 1,937,000 KWHs or approximately \$79,000 in annual savings. *Id.* Lockhart is also in the process of installing electronic radio transmitters in the residential and commercial electric meters. *Id.* at p. 6, ll. 7-8.

Staff, during its audit, verified per book Rate Base of \$16,556,175, of which \$12,630,334 is attributable to South Carolina retail operations. Dowdy Testimony, p. 4, l. 1 – p. 6, l. 5; Hearing Exhibit 4, Audit Exhibit A. To these Rate Base amounts as stated by Lockhart and verified by the Staff, the Commission considers the following test year adjustments to Rate Base as proposed by Lockhart and the Staff:

(a) Accumulated Depreciation - To the per book South Carolina retail electric rate base of \$12,630,334 at December 31, 2001, Lockhart and the Staff proposed certain adjustments. Both Lockhart and Staff proposed an adjustment to adjust Accumulated

Depreciation reserve for the annualized depreciation expense adjustment. Lockhart proposed an adjustment of \$26,594 to increase Accumulated Depreciation. Inman Testimony, p. 4, ll. 14 – 21; Hearing Exhibit 2, Exhibit PWI-7; Hearing Exhibit 4, Audit Exhibit A-1, p. 8 of 12. According to witness Inman, provisions for depreciation on capital expenditures during the test year were made as assets went into service throughout the year. *Id.* Because putting assets into service throughout the year resulted in only a partial year of depreciation expense in the test year, Lockhart normalized the expense to reflect a whole year of depreciation on test year capital expenditures. *Id.* Depreciation expense per books associated with these capital expenditures amounted to \$31,433, whereas, the whole year's depreciation expense amounted to \$58,026. *Id.* Thus, Lockhart proposed to increase Depreciation expense by \$26,593, of which \$20,333 is attributable to South Carolina retail operations.

Staff computed an increase in Depreciation expense of \$47,954, of which \$36,664 is attributable to jurisdictional operations, utilizing allocation rates recommended by the Commission's Utilities Department. Dowdy Testimony, p. 11, ll. 7-14; Hearing Exhibit 4, Audit Exhibit A-1, p. 8 of 12.

The Commission adopts the adjustment proposed by Staff which increases Accumulated Depreciation by \$47,954, of which \$36,664 is attributable to South Carolina retail operations. While Lockhart did not specifically accept the Staff's adjustment at the hearing, Lockhart did state that it did not contest the Staff's proposed adjustment. Further, as the Commission adopted the Staff's proposed adjustment for Depreciation expense due to Staff's adjustment being based on the year-end plant balance

as opposed to Lockhart's adjustment which was calculated on net plant additions during the test year, the Commission finds it appropriate to adopt the Staff's related adjustment to Rate Base. Therefore, the Commission adopts the Staff's proposed adjustment to increase Accumulated Depreciation by \$47,954, of which \$36,664 is attributable to South Carolina retail operations.

(b) Capitalized Wage Increase - Staff also proposed an adjustment to capitalize a portion of the wage increase and benefits associated with the annualization of employee salaries. Dowdy Testimony, P. 11, ll. 15-20; Hearing Exhibit 4, Audit Exhibit A-1, p. 8 of 12. Staff proposed an adjustment of \$7,828, of which \$6,791 is attributable to South Carolina retail operations. Staff made this adjustment to follow the normal booking of wages. A portion of Lockhart's wages, fringe benefits, and FICA taxes are capitalized, that is expenditures are charged to plant rather than expenses, to account for labor costs assigned to capital projects instead of O&M expenses. Staff capitalized 8.38% of the administrative increase and 23.31% of the hourly wage increase. *Id.* These percentages reflect the actual percentages of time spent by administrative and hourly employees on capital projects during the test year. *Id.*

After considering this adjustment, the Commission finds that Staff's adjustment to capitalize a portion of the wage increases should be adopted. The Commission finds it appropriate to capitalize a portion of the wage increases to account for work spent on capital projects.

(c) Accumulated Depreciation - Staff also proposed an adjustment to correct for over-depreciation of Transportation Equipment and Communications Equipment.

Dowdy Testimony, p. 11, l. 21 – p. 12, l. 5; Hearing Exhibit 4, Audit Exhibit A-1, p. 9 of 12. Staff's adjustment consisted of a \$26,817 adjustment for the Transportation Equipment and a \$12,107 adjustment for the Communications Equipment for a total of \$38,924, of which \$29,767 is attributable to South Carolina retail operations. Staff witness Dowdy stated that Lockhart is aware of the over depreciation of these amounts and corrections should be completed by November, 2002. *Id.*

Upon consideration of this adjustment, the Commission finds that the adjustment is reasonable and should be adopted. These adjustments are needed to remove the over-depreciated equipment from these accounts. Depreciation of equipment should not be continued after the equipment is fully depreciated.

(d) Allocation Factors – Both the Staff and Lockhart propose to adjust various rate base accounts for changes in the allocation factor due to the change to kWh sales. Watts Testimony, p.3, ll. 20 – 24; Dowdy Testimony, p. 12, ll. 6 – 9; Hearing Exhibit 4, Audit Exhibit A-1, p. 9 of 12. This adjustment of \$1,777 to Plant in Service for South Carolina retail operations reflects one of the two billing error corrections discussed in “subsection‘b’” of Finding of Fact No. 4 related to adjustments to Operating Revenues. *Id.* That adjustment required the reinsertion of 250,560 kWh into the test year cost of service data resulting in reallocation of Plant in Service and a small increase to the retail jurisdiction of \$1,777. *Id.*

Upon consideration of this adjustment, the Commission finds it reasonable and appropriate. As the Commission adopted the adjustment related to revenues to reverse two billing corrections booked during the test year that in fact related to prior years, it is

appropriate for the Commission to accept the other part of the adjustment that relates to rate base. Accordingly, the Commission adopts this adjustment as proposed by Lockhart and the Staff.

(e) Customer Deposits – Staff proposes to increase Customer Deposits based on the annualization of interest on year-end Customer Deposits using the Commission approved interest rate for Customer Deposits of 8.00%. Dowdy Testimony, p. 12, ll. 10 – 13; Hearing Exhibit 4, Audit Exhibit A-1, p. 10 of 12. The Staff's proposed adjustment is (\$189). *Id.*

Upon consideration of this proposed adjustment, the Commission finds it reasonable and hereby adopts the Staff's proposed adjustment of (\$189) associated with annualizing the interest on year-end Customer Deposits. Lockhart did not contest the Staff proposed adjustment. Further, the Commission finds it appropriate to annualize interest held by Lockhart for Customer Deposits at year end and that the Commission approved interest rate of 8.00% is the appropriate rate to use in this adjustment.

Total Effect of Adjustments to Rate Base - The rate base adjustments adopted above total \$1,614 for South Carolina retail operations. Applying the net total of approved adjustments of \$1,614 to the per book South Carolina retail rate base of \$12,630,334 as of December 31, 2001, results in an adjusted South Carolina retail rate base of \$12,631,948.

Therefore, the proper rate base to be used for ratemaking purposes is included in the following table:

ORIGINAL COST RATE BASE
SOUTH CAROLINA RETAIL ELECTRIC OPERATIONS
DECEMBER 31, 2001

Gross Plant in Service	\$25,150,032
Reserve for Depreciation	<u>(11,383,674)</u>
Net Plant in Service	\$13,766,358
Construction Work in Progress (CWIP)	263,846
Material and Supplies	182,841
Cash Working Capital Allowance	0
Accum. Def. Income Taxes	(1,496,344)
Customer Deposits	<u>(84,753)</u>
Total Original Cost Rate Base	<u>\$12,631,948</u>

9. The capital structure utilized by the Commission in this proceeding for the determination of the fair overall rate of return is the existing capital structure of Lockhart which is comprised of 100% equity with no debt.

In its Application and Prefiled Testimony, Lockhart proposed the use of its existing capital structure which is comprised of 100% equity and no debt as of December 31, 2001. Application, Attachment A-10. Lockhart witness Moul also presented evidence on Lockhart's actual capital structure of 100% equity. *See* Moul Testimony and Hearing Exhibit 3. Staff witness, Dr. Spearman, in his analysis of Lockhart's rate of return, also used Lockhart's actual capital structure of 100% equity with no debt. Spearman Testimony, p. 16, ll. 3 – 13.

As the only evidence before the Commission with regard to analysis of Lockhart's rate of return utilizes Lockhart's existing capital structure of 100% equity with no debt, the Commission finds that Lockhart's existing capital structure of 100% equity with no debt is the appropriate capital structure on which to base Lockhart's overall rate of return in the present rate case.

10. The fair rate of return on common equity, which Lockhart should be allowed a reasonable opportunity to earn, is 11.25% to 11.75%.

One of the principal issues in any ratemaking determination involves the proper earnings to be allowed on the common equity investment of the regulated utility. This Commission has frequently stated that it adheres to no particular theory or methodology for the determination of a fair rate of return on common equity. Rather, the Commission has perceived its function as that of engaging in a careful and reasoned analysis of the theories for application in a practical context.

The landmark decision of the United States Supreme Court in Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923), delineated general guidelines for determining the fair rate of return in utility regulation. In the Bluefield decision, the Court stated

What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional rights to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable

at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.

262 U.S. at 692-3.

During the subsequent years, the Supreme Court refined its appraisal of regulatory precepts. In the frequently cited decision of Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944), the U.S. Supreme Court restated its view thusly

We held in Federal Power Commission v. Natural Gas Pipeline Co., ... [t]hat the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its ratemaking function, moreover involves the making of “pragmatic adjustments.” ... Under the statutory standard of “just and reasonable” it is the result reached not the method employed which is controlling ...

The rate-making process under the [Natural Gas] Act; i.e., the fixing of “just and reasonable” rates, involves a balancing of the investor and the consumer interests. Thus we stated in the Natural Gas Pipeline Co. case that regulation does not insure that the business shall produce net revenues. But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on debt and dividends on the stock. ... By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

320 U.S. at 602-3. (Citations omitted)

The Hope decision thus represented a restatement of the rate of return principles listed by the Court in the earlier Bluefield decision. Moreover, these principles remain as

guidance for determining a fair rate of return. For example, the United States Supreme Court in the case of In Re: Permian Basin Area Rate Cases, 390 U.S. 747 (1968) stated “the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for risks they have assumed, and yet provide appropriate protection to the relevant public interest, both existing and foreseeable.” In Re: Permian Basin Area Rate Cases at 792.

In the final analysis, the Commission must use its judgment in evaluating the evidence in regard to the cost of common equity, which is a matter within the expertise of the Commission.

Lockhart witness Moul testified that in his opinion an overall rate of return of 11.75% is a fair and reasonable return for Lockhart. Testimony of Moul, p. 39, ll. 10- 14. In reaching his recommendation, witness Moul utilized a group of proxy companies to aid in determining an appropriate rate of return for Lockhart. Witness Moul then adjusted his analysis to account for the small size of Lockhart and the lack of debt in Lockhart’s capital structure. Moul Testimony, p. 4, ll. 4-9. Moul also identified Lockhart’s business risk as being dominated by its small size, heavy reliance upon purchased power to meet the energy requirements of its customers, Lockhart’s service area being highly dependent upon the textile and textile related industry, and general uncertainty facing the electric utility industry. Moul Testimony, p. 8, ll. 14-22.

Staff witness Dr. Spearman, the Commission’s Research & Planning Administrator, provided testimony on a recommended return on equity that Lockhart could reasonably expect to earn on its regulated electric operations. Dr. Spearman

testified that he used three methodologies, the Discounted Cash Flow ("DCF") analysis, the Capital Asset Pricing Model ("CAPM") analysis, and the Risk Premium analysis, to estimate the cost of equity appropriate for the regulated electric operations of Lockhart. Spearman Testimony, p. 3, ll. 12 -14. Because Lockhart's common stock is 100% owned by Milliken & Company and is not publicly traded, Lockhart specific data required by the models was not available. *Id.* at p. 3, l. 18 – p. 4, l.2. Therefore, a proxy group of companies was selected. Dr. Spearman selected the electric companies comprising the Moody's Electric Utility Index, excluding Edison International and PG&E Corporation. *Id.* at p. 4, ll. 4 – 9. Dr. Spearman acknowledged that there are no good proxy companies for Lockhart having readily available public data. However, Dr. Spearman offered that the proxy group selected does provide a spectrum of investor-owned utilities and can be used to evaluate the return on investment investors require from electric utility stocks. Spearman Testimony, p. 4, l. 10 – p. 5, l. 18.

Both dividend growth rates and earnings growth rates were utilized in the basic annual constant growth DCF model. Spearman Testimony, p. 7, ll. 17 – 19. The results of the dividend growth provide a floor for the expected return on equity while the results using earnings growth provided a ceiling. *Id.* at p. 7, l. 21 – p. 8, l. 2. Dividend growth rate projections were taken from the Value Line Investment Survey. Earnings growth rate forecasts were taken from Value Line and Zacks which provides a composite forecast based on the forecasts of many stock analysts. The average cost of equity using dividend growth ranged between 7.75% and 8.23%. Spearman Testimony, p. 9, ll. 3 -13; Hearing

Exhibit No. 7, Exhibit JES-5 and JES-6. The average cost of equity using earnings growth ranged between 10.56% and 11.83%. *Id.*

Dr. Spearman's CAPM analysis utilized betas reported by Value Line. Spearman Testimony, p. 10, ll. 13 – 15; Hearing Exhibit 7, Exhibit JES-7. Those were adjusted betas to reflect the perceived long-term tendency of betas to converge toward the market beta of 1.0. *Id.* at p. 10, l. 13 – p. 11, l. 2. The May-July 2002 end-of-month average yields on the 10-year Treasury and 30-year Treasury Bonds and the yields as of August 23, 2002, were used as the risk-free market rate. *Id.* at p. 12, ll. 1 – 14. Based on various measures of total market return, Dr. Spearman determined that a market return in the range of 10.50% to 14.00% to be reasonable. *Id.* at p. 12, ll. 15 -22; Hearing Exhibit 7, Exhibit JES-9. The expected return on equity produced by the CAPM ranged from 7.76% to 10.27%. *Id.*

According to Dr. Spearman, the Risk Premium analysis produced premiums ranging from 3.9% to 5.1%. Adding these premiums to the risk-free rates resulted in return-on-equity estimates in the range of 8.14% to 10.58%.

According to Dr. Spearman, expected DCF return-on-equity estimates based on dividend growth provide very little premium over the Treasury Bond debt, except for the high end of the range. Spearman Testimony, p. 14, ll. 16-17. The DCF estimated return-on-equity based on earnings growth begins at the upper end of the CAPM and the Risk Premium estimates. *Id.* at p. 14, ll. 17-19. The more reasonable range of expected returns-on-equity would fall in the range of approximately 10.25% to 11.75%. *Id.* at p. 15, ll 4-16. Given the turmoil in the energy markets, the high degree of Lockhart's dependence

on the textile industry, and Lockhart's small size, Dr. Spearman concluded that an appropriate return-on-equity for Lockhart would lie in the range of 11.25% to 11.75%. *Id.*

The Commission recognizes the legal principle that the utility be allowed an opportunity to earn a fair return sufficient to enable it to continue to meet its service obligations and to maintain its financial integrity. In considering a reasonable rate of return on equity for Lockhart, the Commission is mindful that Lockhart's size presents risks to Lockhart. Further, the Commission recognizes that Lockhart, by virtue of its strong financial position due to its 100% equity capital structure, may be viewed as a secure company, a fact which usually lowers a risk premium and mitigates against a high return. However, as acknowledged by Mr. Moul and Dr. Spearman, there exists a certain amount of turmoil in the energy markets today. Given that turmoil in the market along with Lockhart's dependence on the textile industry and its small size, the Commission finds that the fair and proper return on common equity is 11.25% to 11.75%. The Commission considers this rate to represent a reasonable expectation for the equity owner. Further, this Commission concludes that a rate of return on equity of 11.25% to 11.75% is sufficient to protect the financial integrity of Lockhart, to preserve the property of the investor, and to permit Lockhart to continue to provide reliable service to present and future customers at reasonable rates.

11. Based upon the specific findings and conclusions herein, Lockhart's annual revenue requirement for its South Carolina retail electric operations is \$12,184,104, which will allow Lockhart a reasonable opportunity to earn a rate of return on its jurisdictional rate base of 11.25% to 11.75%, which the Commission

finds just and reasonable. The rates approved herein are intended to produce additional net revenues for South Carolina retail electric operations of \$644,274, after accounting and pro forma adjustments.

An important function of ratemaking is the determination of the overall rate of return which the utility should be granted. One definition of “rate of return” is

For regulatory purposes, the rate of return is the amount of money earned by a public utility, over and above operating costs, expressed as a percentage of the rate base. In other words, the rate of return includes interest on long-term debt, dividends on preferred stock and earnings on common stock (including surplus or retained earnings). As Garfield and Lovejoy have put it, “the return is that money earned from operations which is available for distribution among the various classes of contributors of money capital. In the case of common stockholders, part of their share may be retained as surplus. The important point to note is that the rate of return includes profit (in the traditional sense), as well as interest on debt capital and dividends on preferred stock.

Phillips, The Regulation of Public Utilities (1993), pp. 375-6.

The amount of revenue permitted to be earned by the Company through its rate structure depends upon the rate base and the allowed rate of return on the rate base. As previously discussed, the primary issue between the regulated utility and the regulatory body most frequently involves the determination of a reasonable return on common equity. Although the determination of the return on common equity provides the necessary component from which the rate of return on rate base can be derived, the overall rate of return, as set by this Commission, must also be fair and reasonable.

The Commission has found that Lockhart’s capitalization ratio as of December 31, 2001, is appropriate and should be used in this proceeding. *See*, Finding of Fact No. 9 and the discussion therein. For the purposes of this proceeding, the Commission finds the

proper cost rate for Lockhart's common equity capital to be 11.25% - 11.75%. *See*, Finding of Fact No. 10 and the discussion therein. Using these findings, the overall rate of return on rate base for Lockhart is 11.25% - 11.75% and may be derived as computed in the following table:

COMPONENT OF CAPITAL STRUCTURE	RATIO (%)	COST RATE (%)	OVERALL RATE (%)
Common Equity	<u>100.00</u>	11.25-11.75	<u>11.25 – 11.75</u>
TOTAL	<u>100.00</u>		<u>11.25 – 11.75</u>

Since the capital structure of Lockhart is 100% equity, the return on common equity is also the overall rate of return on rate base. The Commission finds that a return on rate base of 11.25% - 11.75% is fair and reasonable. However, Lockhart must insure that its operating and maintenance expenses remain at the lowest level consistent with reliable service and exercise appropriate managerial efficiency in all phases of its operations.

Using the approved Operating Expenses of \$10,711,170 (*See*, Finding of Fact No. 6), the total retail Operating Income for Return of \$1,477,943 (*See*, Finding of Fact No. 7), and the 11.25% – 11.75% rate of return on rate base, the Commission finds that Lockhart will require an annual revenue requirement of \$12,184,104 in order to have an opportunity to earn its herein approved rate of return on rate base of 11.25% - 11.75%. To achieve an annual revenue requirement of \$12,184,104, the Commission finds that Lockhart will require additional net revenues from South Carolina retail electric

operations of \$644,274. The annual revenue requirement is illustrated by the following table:

SOUTH CAROLINA RETAIL ELECTRIC

	AS ADJUSTED	EFFECT OF PROPOSED INCREASE	AFTER PROPOSED INCREASE
	\$	\$	\$
Operating Revenues	11,472,633	711,471	12,184,104
Less: Operating Expenses	<u>10,448,239</u>	<u>262,931</u>	<u>10,711,170</u>
Net Operating Income	1,024,394	448,540	1,472,934
Add: Customer Growth	<u>3,484</u>	<u>1,525</u>	<u>5,009</u>
Total Income for Return	<u>1,027,878</u>	<u>450,065</u>	<u>1,477,943</u>
Total Original Cost	<u>12,631,948</u>	<u>0</u>	<u>12,631,948</u>
Rate Base			
Rate of Return on			
Rate Base	<u>8.14%</u>		<u>11.70%</u>

12. The cost of service methodology, rate design, and rate schedules, with the exception of the base amount of the Purchased Power Adjustment clause, as proposed by Lockhart are appropriate and should be adopted for the purpose of this proceeding, including an increase in the reconnect fee from \$5.00 to \$15.00.

The Commission is responsible for the determination of the specific rates and the development of the rate structure that will yield the required revenues. It is generally accepted that proper utility regulation requires the exercise of control over the rate structure to ensure that equitable treatment is afforded each class of customer.

The Commission's statutory responsibility to fix just and reasonable rates has been exercised by the recognition of the objective to provide a utility a fair opportunity to

earn a reasonable return which meets the established revenue requirement and equitably apportions the revenue responsibility among the classes of service. In our discharge of that responsibility, we are mindful of the following criteria:

- (a) The revenue requirement or financial need objective, which takes the form of a fair return standard with respect to private utility companies;
- (b) The fair cost apportionment objective, which invokes the principle that the burden of meeting total revenue requirements must be distributed fairly among the beneficiaries of the service; and
- (c) The optimum use or customer rationing objective under which the rates are designed to discourage the wasteful use of public utility services while promoting all use that is economically justified in view of the relationships between cost incurred and benefits received.

Bonbright, Principles of Public Utility Rates (1961, page 292).

These criteria have been consistently observed by this Commission and again are utilized in this matter.

The cost of supplying electricity to different customers is a function of many factors and variables. The allocation of these costs among the different classes of customers represents a complex task, since many of the total costs of producing energy are common to all customers. The procedure generally used by this Commission in analyzing utility costs in the context of the review of rate design provides for the assignment of the distribution of total costs among three major categories based on (1) costs that are a function of the total number of customers, (2) costs that are a function of the volumes of the service supplied or energy costs, and (3) costs that are a function of the service capacity of plant and equipment in terms of capability of carrying hourly or daily peak loads or demand costs.

In concluding that rates should be based on cost of service principles, the Commission reflects the economic theory that regulation is intended to act as a surrogate for competition by insuring that each rate that is charged for electricity is fair and reasonable, that is, that utility rates are maintained at the level of costs, including a fair return on capital. By incorporating cost of service principles, the Commission provides for rates and charges which are designed to promote equity, engineering efficiency (cost minimization), conservation, and stability.

The foundation for an equitable and efficient cost-based rate structure is a cost study which accounts for the variables and factors from which are derived the cost of supplying electricity to different classes of customers. The cost of service study not only identifies the total cost of service and thereby measures the profitability of the utility but also identifies the cost function and class of service and so measures the compensability of service to any one class. Furthermore, the cost of service study is used to assess the propriety of any one particular rate structure in the design of rates. In a sense, a cost of service study functions as a regulatory guide by which the ratemaker can determine the existing rate of return to each class and the manner and extent to which it should be adjusted to achieve cost-based rates.

Lockhart sponsored cost studies in support of its proposed rates and charges. Lockhart owns and operates an electric system which provides electric energy to approximately 9,390 retail customers, including 5,074 residential customers, 1,123 commercial customers, 11 industrial customers, and 3,177 lighting customers. Hearing Exhibit 5, Part A, p. 1. Lockhart also serves one wholesale customer. *Id.* Each of these

classes of customers contributes different load characteristics and resulting cost-to-serve. *Id.* In order to determine that each customer class is providing adequate revenue to cover the cost-to-serve, a cost-of-service study was performed. *Id.* This study was designed to separate the Company's revenues, expenses, and rate base into proportionate shares for each rate class and jurisdiction. *Id.* In order to accomplish the goal of distributing the revenues, expenses, and rate base categories, Lockhart utilized the "12 Coincident Peak" ("12 CP") method of allocation for the demand-related items. *Id.* Energy-related items were allocated based on the energy used by each class during the test period, and for customer-related items, the number of customers in each class was used to determine the allocations. In all cases where revenues, expenses, or rate base items were for a specific customer, that item was directly assignable. *Id.*

According to Lockhart witness Parmelee, the methodology and format of the cost of service studies filed in the instant proceeding are identical to those of the previous Lockhart rate filing in Docket No. 2000-91-E. Parmelee Testimony, p. 4, l. 21 – p. 5, l. 3. Witness Parmelee prepared three cost of service studies. The Historical Cost of Service Study reflects the costs according to Lockhart's books for the test year ended December 31, 2001. Parmelee Testimony, p. 3, ll. 3 -7. The Historical Study revealed a rate of return for the retail classes of 8.34%. *Id.* The Pro Forma Study differed from the Historical Study as a result of the pro forma adjustments proposed by Lockhart, with the largest adjustment being the decrease in purchased power expense to reflect the removal of the increased purchased power cost during the test period as a result of a shortfall in Lockhart's hydroelectric output due to a severe drought with an offsetting adjustment to

revenues. *Id.* at p. 3, ll.8-24. The Pro Forma Study yielded an overall rate of return of 7.95% and a rate of return of 8.22% for the retail classes. *Id.* The Proposed Study included pro forma adjustments and the proposed revenues for each retail rate class and yielded an overall rate of return of 11.75%, with the rates of return for three of the individual retail rate classes varying from the average rate of return. *Id.* at p. 3, l. 25 – p. 4, l. 13. The residential class yielded a below average 10.02% rate of return, the industrial class yielded an above average rate of return of 14.08%, and the commercial class yielding an above average rate of return of 14.88%. *Id.* The Proposed Study also reflected the revenues for each retail class which would be produced by the rates proposed in Lockharts' rate case based on customer usage in the test year ended December 31, 2001. *Id.* No party took exception with Lockhart's proposed method or advocated another method.

The Proposed Cost of Service Study was the basis for all proposed rates. Although the Proposed Study revealed differences in the rates of return paid by the different rate classes, bringing all classes to equal rates of return would place undue burden on residential customers. *See, Parmelee Testimony*, p. 5, ll. 6 -17. Lockhart proposed to base Industrial revenues on the same 14.08% rate of return which was used in the two previous rate cases, to set Residential revenues at a level which would yield a 10.02% rate of return, and to set Commercial revenues at 14.88%. *Id.* at p. 5, l. 17 – 9. 6, l. 5. No party offered any alternative to Lockhart's proposed returns for the classes. In fact, Staff agreed with Lockhart that bringing all classes to equal rates of return may create an undue burden on some classes, such as Residential. Staff considers a move

toward equal rates of return, rather than attempting to equalize rates of return in a single move, an acceptable means of accomplishing the objective of alleviating or minimizing possible undue burden and rate shock. Watts Testimony, p. 2, ll. 13-27; Hearing Exhibit No. 5, Part C, p. 4. Therefore, based on the reasoning propounded by Lockhart and the Staff, the Commission adopts Lockhart's proposed revenue distribution by classes as the basis on which to design the new rate schedules.

The Commission hereby directs Lockhart to file rates which produce the additional revenue requirement of \$100,308 based on the allowed net increase of \$644,274, which is found fair and reasonable herein, and to distribute the additional revenue responsibility consistent with the distribution approved in the preceding paragraph.

Further and as a result of the adjustments approved herein, the base rate Purchased Power level to be included in the approved rates is 3.4438 cents per kilowatthour.

Lockhart also proposed to increase its Customer Reconnect fee from \$5.00 to \$15.00 per reconnect. Application, p. 2, ¶16; Application, Exhibit A3-8; Inman Testimony, p. 3, ll. 10-18. Lockhart states that the Reconnect Fees as currently collected are credited against Lockhart's collection expense as an offset to the costs of reconnect. *Id.* Lockhart provided justification of its requested increase by providing evidence that the cost of the reconnect is \$24.28 per reconnect. *Id.* Upon analysis of the costs for the reconnect and the proposed fee, the Commission approves the requested increase for the Reconnect Fee.

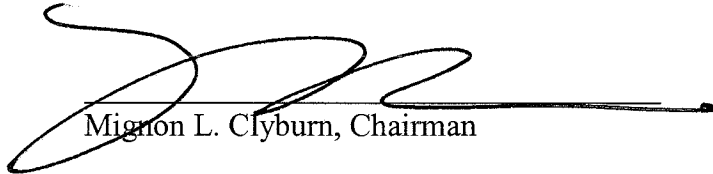
IT IS THEREFORE ORDERED THAT:

1. Lockhart shall implement rate designs and rate schedules for service consistent with the revenue distribution as found reasonable herein and consistent with the findings set forth herein with such rate designs and rate schedules to be effective for service rendered on or after the date of this Order.

2. Lockhart shall file within ten (10) days from receipt of this Order, rate schedules in accordance with the findings contained herein.

3. This Order shall remain in full force and effect until further Order of the Commission.

BY ORDER OF THE COMMISSION:



Mignon L. Clyburn, Chairman

ATTEST:



Gary E. Walsh, Executive Director

(SEAL)